How to Win the Valuation Battle: An Overview of Critical Reorganization Valuation Issues

TMA 2005 Annual Convention

October 20, 2005 (Concurrent Session B2)

Agenda

Panel Description

Panel Introductions

Reorganization Value Background

Key Valuation Issues: The Battle Fronts

Common Mistakes: The Custer Effect

Questions & Answers

Panel Description & Introductions

Panel Description

- This panel of seasoned experts will discuss the key valuation issues in bankruptcy and restructuring battles
- The panelists will outline their “Top 5” valuation issues for which consensus is vital to a successful outcome
- The panelists will also expose some of the common technical errors made by “valuation professionals”

Panelist Introductions

Carl Lane	Deloitte Financial Advisory Services LLP
Ira Wolfson	Rothschild Inc.
Shez Bandukwala	ThinkEquity Partners, LLC
Michael Henkin	Jefferies & Company, Inc.
Bernard Pump	Deloitte Financial Advisory Services LLP

Carl Lane, Principal
Deloitte Financial Advisory Services LLP

- Midwest practice leader of the Reorganizations Services Group
- Over 15 years of experience as a financial consultant, focusing on providing reorganization and restructuring consulting to major distressed companies, creditors, shareholders, and other interested parties
- Provided expert testimony on numerous occasions on bankruptcy court matters associated with valuation, market rates, feasibility and substantive consolidation
- Also provided dispute consulting with respect to financial, accounting, and valuation issues, especially as they relate to damage calculations
- BS in Accounting – University of Florida
- MBA in Finance – University of Florida
- CIRA, CFA and CMC

ROTHSCHILD

- Director, M&A and Restructuring (2001 – Present) with over 10 years of investment banking experience
- Participated in over 40 transactions with aggregate value exceeding $50 billion
- Prior to joining Rothschild, was a Vice President with Thomas Weisel Partners focused on M&A and capital raising transactions and private equity investments and was with ING Barings Furman Selz for 5 years specializing in Mergers & Acquisitions
- Recent transactions include United Airlines, WestPoint Stevens, Federal-Mogul Corporation, Emerald Casino, Dow Corning Corp., Textron, ITT Industries, DynCorp, Guilford Mills, Cerberus Capital, Vivendi Universal, Tower Automotive, Thermadyne Holdings
- BA – Duke University

Shez Bandukwala
ThinkEquity Partners, LLC

ThinkEquity Partners LLC

- Head of Consumer, Education Investment Banking
- Founding President, Hilco Enterprise Valuation Services (2002-2005)
  - Led 120 cases in three years
- Partner, William Blair & Company (1992-2002)
  - 60 transactions, $4 billion transaction value
- BS – University of Illinois
- MBA – Northwestern University, Kellogg Graduate School of Management

Michael Henkin
Jefferies & Company, Inc.

Jefferies

- Sr. VP, Restructuring and Recapitalization Group, Jefferies (1991-1994, 2001-present)
  - Over 40 transactions, 10+ Chapter 11 cases
  - Expert testimony on valuation, feasibility, debt capacity, financing, and other issues
- Operating company experience (News Corp., Loral Space, and NextEngine)
- MBA – Stanford Graduate School of Business
- BA in Economics/Business – University of California, Los Angeles

Bernard Pump, Partner
Deloitte Financial Advisory Services LLP

Deloitte.

- Partner in the Valuation Services practice with over 18 years of financial consulting and accounting experience
- Has provided valuation services in the context of bankruptcies and reorganizations for the following purposes: adequate protection of collateral, negotiating plans of reorganization, preparation of disclosure statements, debt to equity conversions, solvency analyses and debt covenant reviews
- Has spoken on the valuation of businesses in bankruptcy at the national conference of the Association of Insolvency and Reorganization Advisors, U. of Texas VALCON Conference, the Chicago Bar Association, the Tax Executive's Institute, and to various banks, law firms and industry groups
- Co-author and instructor of the AIRA's certification for distressed business valuation (CDBV) curriculum
- MBA – University of Chicago Graduate School of Business
- MA in Economics – University of Chicago, Department of Social Sciences
- BS in Economics – University of Pennsylvania, Wharton School of Finance
- CPA, CMA, CIRA, CDBV, CBA, ASA (Candidate Member)

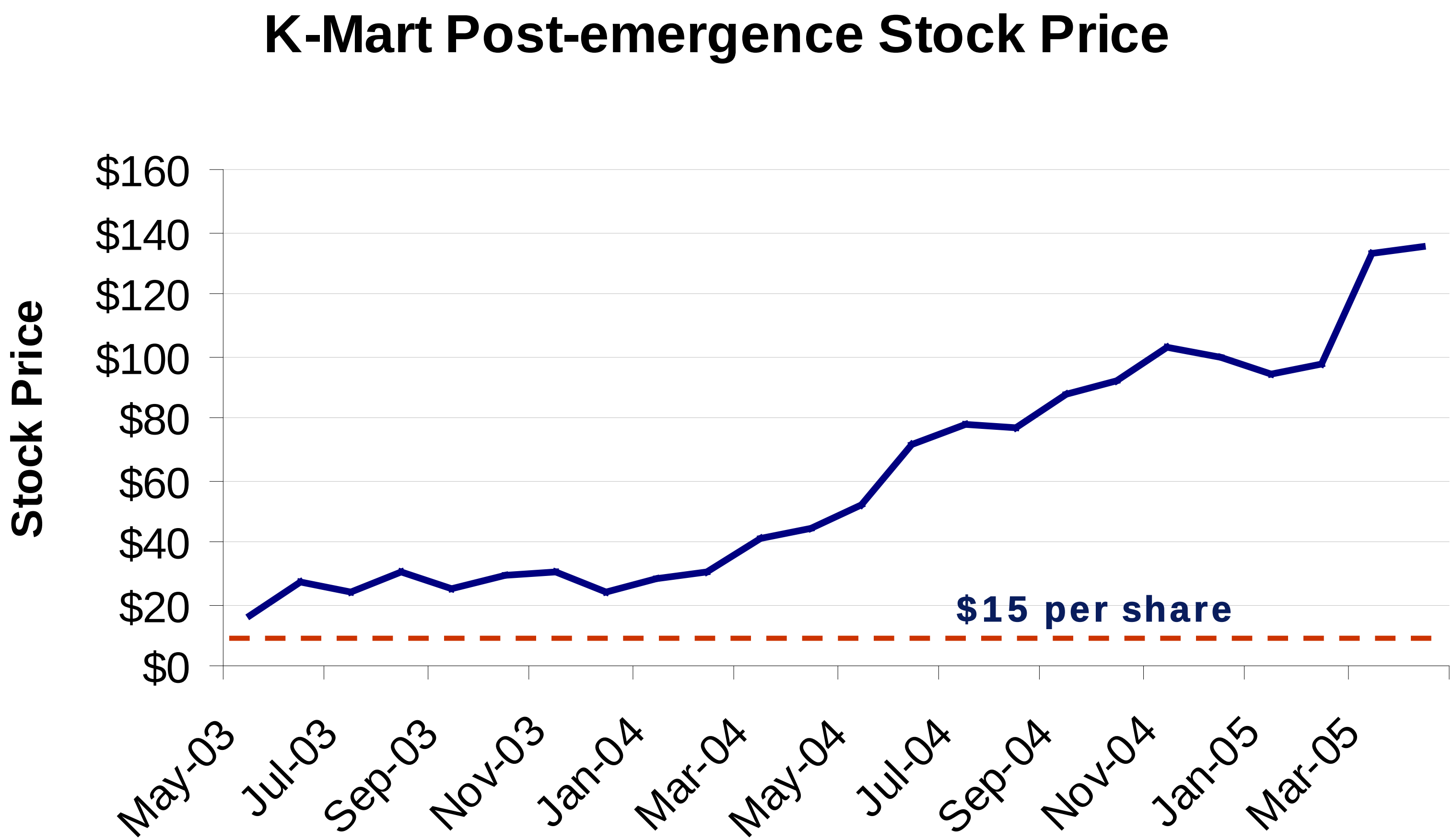
Reorganization Value

- Definition of Reorganization Value
  - Should approximate fair market value of the reorganized debtor, before considering liabilities, based on what a willing buyer would pay a willing seller for the assets or enterprise
  - Should include all elements of value that would be available as of the effective date to satisfy allowed claims and interests
- Underlying Core of Ch. 11 Reorganization
  - Determines whether and to what extent creditors and equity holders will be entitled to any distribution

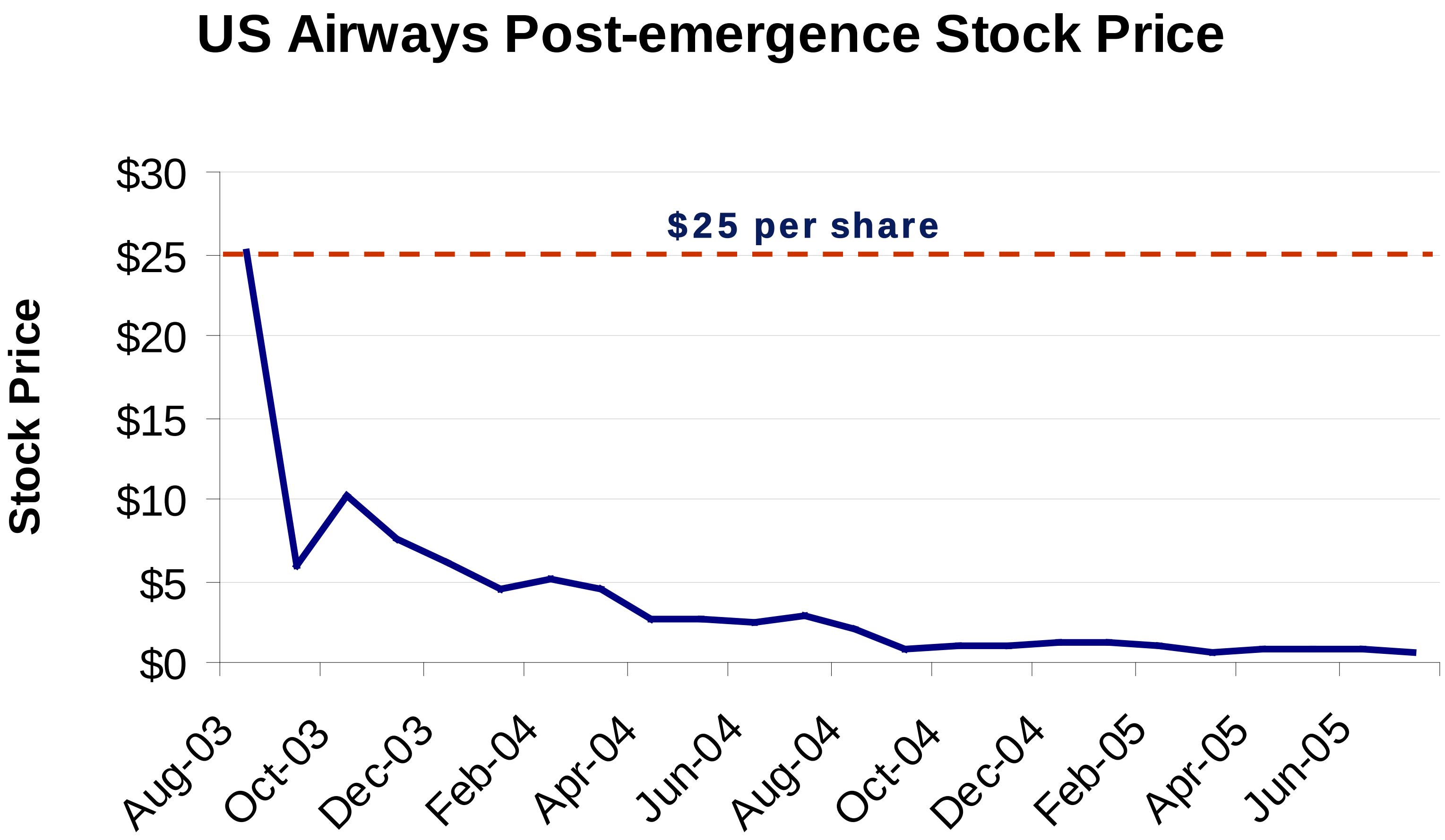
Recent Cases

- Bush Industries
  - Qualitative adjustments by valuation experts are appropriate and necessary
- Mirant Corp.
  - Court directed revised valuation calculation with key assumptions specified
- Exide Technologies
  - Testimony that “strategic distortion” results from relative bargaining strength of claimholders and shareholders and whether management had equity ownership, among other factors

K-Mart – Estimate v. Market



US Airways – Estimate v. Market



The Battle Fronts

Key Valuation Issues: The Battle Fronts

- Reasonableness of Projections
- Normalizing Earnings
- Non-operating Assets
- Over-reliance on Specific Valuation Approach
- Risk Adjustments to WACC and Market Multiples

Reasonableness of Projections

Reasonableness of Projections

- A 1999 study showed that cumulative projection error for EBIT was 70% in year 2 and 180% in year 4
  - Source: "Warm with Sunny Skies”: Disclosure Statement Forecasts, Betker, Ferris and Lawless, *American Bankruptcy Law Journal*, Fall 1999

Importance of Projections

- "The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disasters, and if the allocation of securities...is to be fair and equitable."
  - Source: *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510, 526, 61 Supreme Court decision, 675, 685, 85 L.Ed. 982, 1941
- "Where a debtor proposes to fund a plan out of operating revenue, its financial record during the pendency of Chapter 11 is probative of feasibility. Income projections indicating financial progress must be based on concrete evidence of financial progress, and must not be speculative, conjectural or unrealistic predictions."
  - Source: *In re: Merrimack Valley Oil Co., Inc.*, 32 B.R. 485, 488, 1983

Key Issues with Management Forecasts

- Historical success in meeting projections is relevant
- Changes in industry fundamentals can impact projections
- Need to consider multiple scenarios
- Due diligence on reasonableness of assumptions is key
- Adjusting management forecasts requires convincing evidence

Normalizing Earnings

Types of Adjustments

- Non-recurring or One-time Costs
- Unusual or Extraordinary Items
- Out-of-period Revenue and Expense
- Non-operating Income and Expenses
- Reorganization and Restructuring Cost
- Normalizing Adjustments
- Pro forma Adjustments
- Effects of Change in Accounting Standards or Estimates (e.g., accounting for options)

Key Issues with Adjusting Earnings

- All significant adjustments need to be explained and supported
- Must be consistent with forecast assumptions
- May need to adjust multiples if adjustments reflect projected effects (e.g., use forward multiples)
- Some level of non-recurring and out-of-period items occur each year
- Magnitude of adjustment, up or down, and number may be conceived as “strategic distortion”
- Consistent adjustments should be made for peer companies, if possible

Non-operating Assets

Net Operating Loss Carry-forwards

- Consider calculating the NOL value separately from the DCF
  - Use taxable income projections to use up available NOL
- The equity cost of capital may be more appropriate than the WACC
  - The NOL benefits the equity holders
  - The NOL is only valuable if there is positive IBT
- The WACC should still be tax-effected even if the NOL eliminates taxes
  - Interest expense reduces taxable income before the NOL can be utilized

Excess Cash

- Definition and treatment varies across practitioners
  - Cash and working capital balances can fluctuate widely over time and from company to company
- Calculation of normalized cash / working capital should be supported
  - Cash flow forecasts
  - Industry norms
  - Company history
- Market multiples are typically calculated excluding cash
  - Buyers do not pay multiples for cash
  - Cash should be added back after calculating value when using a multiples approach if cash is subtracted when calculating multiples

Excess Cash (cont.)

- There are differing philosophies regarding the treatment of excess cash in an income approach
  - All cash is excess cash
    - Cash is cash - whether in a bank account or in a cash flow forecast
    - Cash is treated as a dollar for dollar adjustment at closing
  - Only ‘war chest’ cash is excess cash
    - Cash is needed on the day after the closing to run the business
    - A high or low cash balance is assumed to be temporary and offset elsewhere on the balance sheet
  - Cash balances above a ‘normalized’ level is excess cash
    - The middle ground
    - Requires substantial analysis and support

Intangible Assets

- Statutory-based assets
  - Patents, copyrights, trademarks, trade names
- Customer-based or market-based assets
  - Customer lists
  - Customer routes
- Contract-based assets
  - Customer contracts for services
  - License agreements
  - Leases
  - Rights
- Technology-based assets

Over-reliance on Valuation Approach

Typical Valuation Approaches

- Income Approach – Discounted Cash Flow ("DCF") Analysis
- Market Approach - Comparable or Guideline Public Company Analysis
- Market Approach – Precedent or Guideline or Transaction Analysis

Over-reliance on Valuation Approach

- The survey below is based on an unscientific sampling of 30 expert valuations since 2001:

	Discounted Cash Flow ("DCF")	Trading Comparables	Precedent Transactions	Other (1)
Average weightings	58%	28%	12%	2%
Number of reports with entire weighting assigned to one methodology	6	1	0	0

(1) Includes the following:

Liquidation approach

Market cycle approach

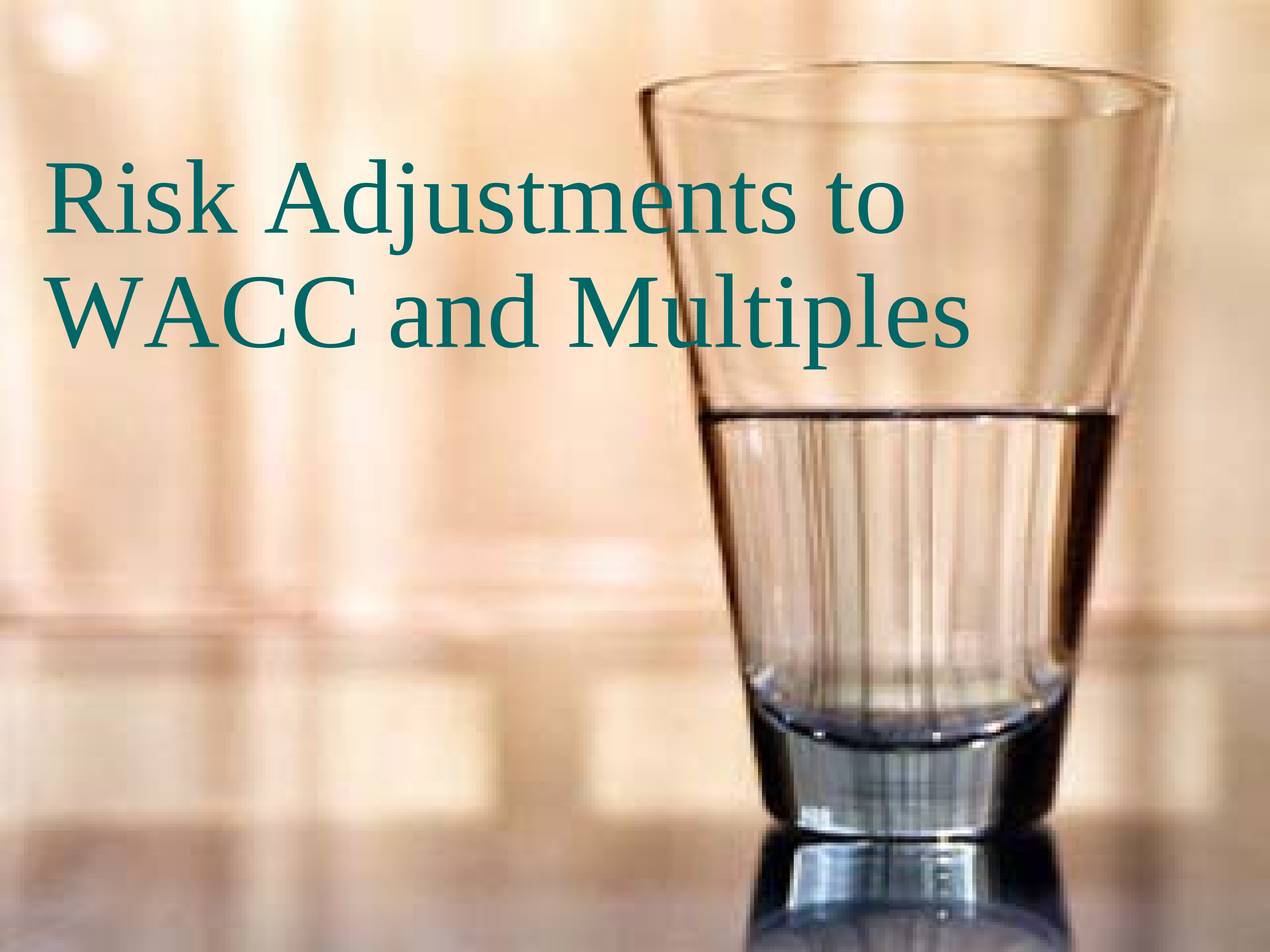
Private equity bid approach

Auction process approach

Over-reliance on Valuation Approach (cont.)

- Reasons cited for overweighting methodologies
  - Lack of appropriate trading or precedent transaction comparables
  - Volatile or negative near-term cash flows
  - Need for long-term view of cash flows
  - Relevance of alternative methodologies

Risk Adjustments to WACC and Multiples



Operational and Restructuring Risk

- Financially distressed companies face two types of risk
  - Operational risk – Risk to enterprise
  - Restructuring risk – Risk to stake holders
- Two types of risk are very different and require different approaches to determine the appropriate risk premiums
  - Operational risk is addressed at the enterprise-level valuation
  - Restructuring risk is addressed as a discount to the value of the class of debt or equity

Two Types of Financially Distressed Companies

- Good companies with bad balance sheets
  - Over-leveraged, but otherwise operationally healthy
  - Expectations concerning future results have not been achieved
  - Typically profitable at EBIT level
  - Principally face financial restructuring risk
  - Very low probability that likely result of restructuring will be liquidation
- Bad companies with bad balance sheets
  - Significant operational problems in addition to being over-leveraged
  - Typically unprofitable at EBIT level
  - Principally face operational and financial restructuring risk

Risk Adjustments Should Be Supported

- Typical support provided is ‘appraiser’s judgment’
- Meaningful analysis can be presented to validate judgment
  - Provides additional credibility and independent reference
- Supporting analysis should be based on market evidence
  - Credit scoring can be used to quantify incremental risk
  - Analysis of Beta regression can yield insight
- Be consistent between the income and market approaches
  - The use of a specific company risk factor in the discount rate implies an adjustment to the multiples

The Custer Effect

Common Mistakes: The Custer Effect

- Math Errors and Short Cuts
- Ignoring Preferred Stock in MVIC and Debt to Equity Ratios
- Blindly Using Book Value of Debt for Distressed Peers
- Inconsistent Reference Periods for Multiples and Financial Results
- Inconsistent Adjustments to Subject's and Peers' Earnings
- Use of Preliminary or Unreliable M&A Data

Questions & Answers